No. 95-154

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Petitioners,

v.

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For Writ Of *Certiorari* To The United States Court Of Appeals For The Ninth Circuit

PETITIONERS' REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF *CERTIORARI*

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TABLE OF CONTENTS

Page

I. A WRIT OF CERTIORARI SHOULD BE GRANTED ON THE ISSUE OF AUDITOR SCIENTER UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 ("SECTION 10(b)") 1

A. The Ninth Circuit's Rulings Regarding Auditor Scienter Constitute a Radical and Dangerous Departure from Settled Law Under Section 10(b), and Require Review by This Court..... 1

B. The Ninth Circuit Improperly Held that Where Expert Witnesses Disagree Regarding the Validity of an Auditor's Accounting Determinations, the Auditor is Entitled to Summary Judgment 4

C. The Ninth Circuit's Opinion Conflicts with the Opinions of Other Circuits 6

II. A WRIT OF CERTIORARI SHOULD BE GRANTED TO REVIEW THE NINTH CIRCUIT'S RULINGS REGARDING THE "BESPEAKS CAUTION DOCTRINE", NON-AUDITOR SCIENTER AND SUMMARY JUDGMENT STANDARDS UNDER FED. R. CIV. P. 56 8

A. The "Bespeaks Caution Doctrine" 8

B. Non-Auditor Scienter..... 9

C. Summary Judgment Standards..... 9

III. CONCLUSION..... 10

TABLE OF AUTHORITIES

Page

CASES

Ambrosini v. LaBarraque, 966 F.2d 1464 (D.C. Cir. 1992) 7

Eastman Kodak Co. v. Image Technical Services, ___ U.S. ___, 112 S.Ct. 2072 (1992) 5

Endo v. Albertine, 863 F.Supp. 708 (N.D. Ill. 1994) ...3, 7

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 2, 6

Fine v. American Solar King, 919 F.2d 290 (5th Cir. 1990), *cert. dismissed*, 502 U.S. 976 (1991) 7

Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) 7

Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27 (2d Cir. 1976) 3

Hughes v. American Jawa, Ltd., 529 F.2d 21 (8th Cir. 1976) 7

In re Apple Computer Securities Litigation, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990) 5

In re Worlds of Wonder Securities Litigation, 35 F.3d 1407 (9th Cir. 1994) ..... *passim*

SEC v. Price Waterhouse, 797 F.Supp. 1217 (S.D.N.Y. 1992) 2, 3, 4, 6

United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) 7

TABLE OF AUTHORITIES – Continued

Page

STATUTES AND RULES

Securities Act of 1933

§11, 15 U.S.C. §77k 10

§12, 15 U.S.C. §77*l*(2) 10

Securities Exchange Act of 1934

Section 10(b), 15 U.S.C. §78j(b) 1, 2, 3, 7, 9

Federal Rules of Civil Procedure

Rule 56 ..... 8, 10

OTHER AUTHORITIES

D. Langevoort, *Disclosures That "Bespeak Caution"*, 49 Bus. Law. 481 (1994) 8

Petitioners Rosetta Miller *et al.* (the "Investors") submit this Reply Brief in support of their petition for a writ of *certiorari* to review the Ninth Circuit's decision in *In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407 (9th Cir. 1994) ("*WOW II*").

I. A WRIT OF CERTIORARI SHOULD BE GRANTED ON THE ISSUE OF AUDITOR *SCIENTER* UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 ("SECTION 10(b)")

A. The Ninth Circuit's Rulings Regarding Auditor *Scienter* Constitute a Radical and Dangerous Departure from Settled Law Under Section 10(b), and Require Review By This Court

The Ninth Circuit's rulings regarding the legal standards for determining an auditor's *scienter* under Section 10(b) require review by this Court because they depart drastically from settled law and threaten the integrity of securities markets. The arguments made against review by respondent Deloitte & Touche LLP ("Deloitte") are uniformly without merit. First, Deloitte contends that the Ninth Circuit's decision reflects nothing more than a determination that the Investors' factual showing was inadequate. However, this contention is incorrect. The Ninth Circuit criticized the Investors' evidence, but only because that evidence did not satisfy the erroneous legal standard for auditor *scienter* which the Court adopted. There was nothing wrong with the Investors' evidence – under a proper legal standard, it would have been held to be more than sufficient to establish the existence of triable issues of fact regarding *scienter*. The Ninth Circuit's adoption of an inappropriate legal standard should be reviewed by this Court.

Deloitte further argues that granting the writ would embroil this Court in narrow factual disputes of little relevance to other cases. However, this assertion is incorrect. Indeed, contrary to Deloitte's contention, the two *key* facts regarding Deloitte's *scienter* – the material falsity of the financial statements and Deloitte's contemporaneous

knowledge of the facts which rendered them false – were undisputed in the Ninth Circuit, and they are undisputed here. These two facts – falsity and knowledge – were sufficient to establish a *prima facie* case of *scienter* under settled law.[1]

Yet, the Ninth Circuit held that proof of falsity and knowledge does not even raise a *jury question* regarding *scienter*. *WOW II*, 35 F.3d at 1426. Rather, the Court held that *scienter* is lacking as a matter of law, irrespective of the defendant's knowledge or intent, unless the plaintiff proves

> . . . that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted by the same facts.

WOW II, 35 F.3d at 1426 (quoting *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)). The adoption of the *Price Waterhouse* test as the exclusive standard for auditor *scienter* was grievous legal error. All other courts of appeals which have addressed the issue have held that proof of intentional, knowing or reckless conduct satisfies the element of *scienter*. *See* Investors' Petition, at 20-21. Paradoxically, under the Ninth Circuit's *Price Waterhouse* standard, *only* reckless conduct suffices for liability.[2]

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[1] *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (Section 10(b) proscribes knowing misrepresentations). *See also* cases cited in the Investors' Petition, at 20-21.

[2] Deloitte does not even try to defend the proposition that the only way to prove *scienter* is to satisfy the *Price Waterhouse* recklessness test. Instead, Deloitte denies that the Ninth Circuit intended the *Price Waterhouse* standard to be the exclusive test for *scienter*. Deloitte Br. at 8-9 n.5. According to Deloitte, the Ninth Circuit relied on a recklessness test because it found that the Investors introduced no "direct evidence" of Deloitte's

Deloitte also disputes the Investors' contention that making a false statement with knowledge of the facts which render it false is sufficient to raise triable issues regarding *scienter*. Rather, Deloitte argues that to defeat summary judgment on the issue of *scienter*, a Section 10(b) plaintiff must show not only that the defendant made the statement and knew the facts which rendered the statement false, but also that the defendant knew the falsity of the statement. Deloitte Br. at 10 n.6. To the extent that this argument is comprehensible, it is wrong. Knowledge of the facts which render a statement false *is* knowledge of the statement's falsity.[3] At a minimum, it raises triable issues of fact with respect to falsity.[4] Indeed, it is unclear how a plaintiff could do more to establish the existence of a triable issue of fact on the issue of *scienter* than to prove that the defendant made a false representation despite his knowledge of the facts which rendered it false.[5] To

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knowledge. *Id.* However, Deloitte's argument mischaracterizes the Ninth Circuit's analysis. The Court *explicitly* held that proof of knowing or even deliberate misrepresentations does not establish *scienter*, and that satisfaction of the *Price Waterhouse* recklessness test is a prerequisite for section 10(b) liability. This novel ruling should be reviewed by this Court on *certiorari*.

[3] *See, e.g., Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33 (2d Cir. 1976) (trial verdict for plaintiff affirmed where auditor "had actual knowledge of the omitted facts which rendered its report misleading").

[4] *E.g., Endo v. Albertine*, 863 F. Supp. 708 (N.D. Ill. 1994) (expert accounting testimony that auditor knowingly failed to disclose material information raised an inference of *scienter*).

[5] Here, for example, plaintiffs showed that Deloitte approved revenue recognition on massive, end-of-year transactions. SEC Rules and Generally Accepted Accounting Principles required the transactions to satisfy seven conditions to merit revenue recognition. The evidence – not only the declaration of accounting and auditing expert Albert Rossi but the actual contracts for the transactions – established that the transactions failed to satisfy at least *five* of the seven conditions. Deloitte had

require more would be to insist on proof of a subjective intent to defraud, which no court has required as a condition of establishing *scienter.*

B. The Ninth Circuit Improperly Held that Where Expert Witnesses Disagree Regarding the Validity of an Auditor's Accounting Determinations, the Auditor Is Entitled to Summary Judgment

The Ninth Circuit improperly held that a Section 10(b) plaintiff cannot defeat an auditor's summary judgment motion if the auditor submits expert testimony attesting to the reasonableness of its accounting determinations. Deloitte disputes this reading of the *WOW II* opinion. However, Deloitte's reading is not only incorrect but is itself so troubling that this Court should grant review.

According to Deloitte, the Ninth Circuit held only that "the trial court was not required to defer to the nonmovant's expert testimony on summary judgment when the evidence in support of the moving party is *otherwise clear.*" Deloitte Br. at 11 (emphasis added). However, this interpretation of the Ninth Circuit's ruling is wrong. The Court's conclusion that Deloitte's evidence "negated" the Investors' attempt to establish *scienter* is followed directly in the *WOW II* opinion by a quotation from *Price Waterhouse, supra,* to the effect that where "complex issues of accounting" are in dispute, and experts on both sides present "diametrically opposing views", "no finding of fraud or recklessness can rationally be made . . . " 35 F.2d at 1426.

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the contracts, reviewed them and was aware of the terms of the deals. The auditors were also obviously chargeable with knowledge of the relevant accounting rules and principles. What more could a plaintiff show to establish knowledge of the falsity of the audited financial statements?

Thus, the Ninth Circuit held that Deloitte's evidence "negated" the Investors' evidence not because the record was "otherwise clear", but because the Court believed "no finding of fraud or recklessness [could] rationally be made" due to the presence of conflicting expert declarations reflecting "diametrically opposing views". This revolutionary and dangerous holding merits review by this Court.

Even if Deloitte's interpretation of the Ninth Circuit's opinion is correct, and the Court has merely held that the plaintiff's evidence on summary judgment may be ignored where the evidence is "otherwise clear", the ruling must be reviewed. Contrary to Deloitte's contention, no case prior to the *WOW II* opinion has held that evidence submitted in opposition to a summary judgment motion may be disregarded under Rule 56 merely because the evidence submitted by the *moving* party is "otherwise clear". No matter how "clear" the moving party's evidence may be, summary judgment may not be granted where the opposing party has submitted evidence which, if credited by the trier of fact, would support a verdict in the nonmoving party's favor at trial. *Eastman Kodak Co. v. Image Technical Services*, ___ U.S. ___, 112 S.Ct. 2072 (1992).[6]

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[6] In support of the proposition that courts are free to disregard expert testimony on summary judgment, Deloitte and the Ninth Circuit rely on *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1116 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). However, *Apple* is inapposite. In *Apple*, the expert's declaration concerned a matter so within the common experience of jurors that a jury could make up its own mind without expert guidance. Here, nobody claims that accounting and auditing are subjects a reasonable juror would know about. Expert testimony is necessary and it cannot be disregarded simply because it conflicts with the opinion of the other side's expert witness. The other cases cited by Deloitte on this point (Deloitte Br. at 14-15) are similarly distinguishable – none of them involved expert testimony disregarded by a court simply because it conflicted

C. The Ninth Circuit's opinion Conflicts with the Opinions of other Circuits

The *WOW II* opinion holds that even proof of intentional or knowing material misrepresentations, without more, cannot prove an auditor's *scienter* – only proof of a certain type of recklessness is sufficient, under the Court's interpretation of the *Price Waterhouse* test. In so holding, the opinion directly conflicts with the holdings of other circuits (and the opinion of this Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)) that proof of intentional or knowing misstatements *does* satisfy the *scienter* requirement. *See* Investors' Petition, at 20-21. Deloitte's attempt to rebut the existence of this conflict (Deloitte Br. at 12) focuses only on the illusory distinction between knowledge of facts which render a statement false and knowledge of the falsity of the statement. Deloitte does not grapple with the fundamental contradiction between the holdings of other circuits that knowledge or intent are sufficient to prove *scienter* and *WOW II*'s holding that knowledge and intent are *insufficient*.

An additional conflict between the circuits requires review by this Court – the conflict between the Ninth Circuit's holding that there can be no *scienter* where an auditor submits expert testimony in support of the reasonableness of his accounting determinations and the holdings of other circuits that conflicting expert testimony precludes summary judgment.[7] Deloitte argues that

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with the testimony of the opposing party's expert. Moreover, Deloitte cites not a single case which suggests that a court can disregard the comprehensive *non-expert* evidence of *scienter* submitted by the Investors here, including Deloitte's own *concession* that it knew the facts which rendered the financial statements false, but nevertheless certified them and disseminated them notwithstanding that knowledge.

[7] Even outside the accounting context, other circuits have held that summary judgment is unavailable where the nonmoving party contests the moving party's showing by submitting

there is no conflict because the plaintiffs in the cases cited by the Investors presented other evidence in support of *scienter* in addition to expert testimony. However, this does not negate the existence of a conflict. First, there was ample non-expert evidence of *scienter* presented here, too, all of which the Ninth Circuit disregarded.[8] Furthermore, the fact that the courts in the cases cited by the Investors also looked at non-expert evidence does not alter their holdings that competent, admissible expert testimony precludes summary judgment in favor of an auditor defendant under Section 10(b). For example, in *Fine v. American Solar King*, 919 F.2d 290, 297 (5th Cir. 1990), *cert. dismissed*, 502 U.S. 976 (1991), the Fifth Circuit held that an expert declaration similar to Mr. Rossi's "suffice[d] to create a triable issue" on an auditor's *scienter*. Similarly, in *Endo v. Albertine, supra*, 863 F. Supp. at 728 n.41, the Court denied an auditor's summary judgment motion on the issue of *scienter* based on the testimony of the plaintiff's expert witness.

Finally, Deloitte purports to distinguish *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), on the grounds that the Court relied principally on other evidence to establish criminal intent in a prosecution for disseminating false financial statements. However, the fact remains that in *Simon*, a jury verdict was upheld despite conflicting expert testimony regarding the *reasonableness of the auditors' accounting determinations*. Under *WOW II*, that verdict would have been

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the declaration of a qualified, competent expert. *Ambrosini v. LaBarraque*, 966 F.2d 1464, 1470-71 (D.C. Cir. 1992); *Hughes v. American Jawa, Ltd.*, 529 F.2d 21 (8th Cir. 1976).

[8] Deloitte relies on the Ninth Circuit's statement that the Investors did not introduce any "direct" evidence of *scienter*. However, as this Court has cautioned, direct evidence of a defendant's state of mind is seldom available, and therefore, proof of *scienter* must often be a matter of inference from circumstantial evidence. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 (1983).

reversed. Thus, there is a conflict requiring this Court's intervention.

II. A WRIT OF CERTIORARI SHOULD BE GRANTED TO REVIEW THE NINTH CIRCUIT'S RULINGS REGARDING THE "BESPEAKS CAUTION DOCTRINE", NON-AUDITOR *SCIENTER* AND SUMMARY JUDGMENT STANDARDS UNDER FED. R. CIV. P. 56

A writ of *certiorari* should also be granted to review the Ninth Circuit's rulings regarding the "bespeaks caution doctrine" and the *scienter* of the Officer, Director and Venture Capitalist defendants, as well as the Ninth Circuit's denial of the constitutional right to a jury trial through the misapplication of summary judgment standards.

A. The "Bespeaks Caution Doctrine"

The Respondents contend that the writ should be denied as to the "bespeaks caution doctrine" because the Investors challenge only the Ninth Circuit's "application (not adoption)" of that doctrine. This argument lacks merit. While many lower courts have adopted something they have called the "bespeaks caution doctrine", there is no general agreement regarding what that "doctrine" means or how it is to be applied.[9] The Ninth Circuit in *WOW II* has applied the "doctrine" in a fashion which conflicts with this Court's teachings regarding materiality and adequacy of disclosure, and which controverts the rulings of other circuits regarding whether "risk disclosures" can render immaterial misrepresentations of existing facts. The question of the applicability of the "bespeaks caution doctrine" is of great importance to the

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[9] *See, generally,* D. Langevoort, *Disclosures that "Bespeak Caution"*, 49 Bus. Law. 481 (1994) (distinguishing between various versions or interpretations of the "doctrine").

securities markets. Issuers of securities, investors and regulators all require this Court's guidance regarding the scope and limits of the "bespeaks caution doctrine". Notwithstanding the Respondents' contrary contentions, the issue is fairly presented on this record. Accordingly, a writ should be granted to review this issue.

B. Non-Auditor *Scienter*

The Respondents contend that the issue of *scienter*, in the context of the Investors' Section 10(b) claims against the Officer, Director and Venture Capitalist defendants, is not suitable for review because the Ninth Circuit's grant of summary judgment on this issue was based on a failure of proof by the plaintiff, not on a ruling that the defendants' evidence demonstrated an absolute bar to liability. However, the Respondents are wrong. There was no failure of proof – the Ninth Circuit granted summary judgment to the Officers, Directors and Venture Capitalists because it found that these defendants' "overall pattern of conduct rebuts any inference of *scienter*". *WOW II*, 35 F.3d at 1424, 1427-28.[10] The factors which the Court held conclusively rebut *scienter* cannot do so, as a matter of law. *See* Investors' Petition, at 27-29. Thus, this issue merits review by this Court.

C. Summary Judgment Standards

The Respondents argue that review of the Ninth Circuit's application of summary judgment standards is inappropriate both because the Ninth Circuit applied the correct summary judgment standards and because the Ninth Circuit's treatment of the issue will not affect other cases. They are wrong on both counts. In disregarding

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[10] The Ninth Circuit stated that the Investors had not presented "direct" evidence of the Officers', Directors' and Venture Capitalists' *scienter*. However, as noted above (*see supra*, n.8) this Court has held that *scienter* need not be, and often cannot be, proven by "direct evidence".

substantial evidence submitted by the Investors, weighing that evidence against the evidence submitted by Respondents and declining to extend legitimate inferences in favor of the Investors, the Ninth Circuit acted in a manner inconsistent with the Rule 56 standards promulgated by this Court, and in violation of the Investors' constitutional right to a jury trial. Moreover, the issue of how the standards of Rule 56 are to be applied consistent with constitutional and due process guarantees is of significant importance to the administration of justice in the federal courts. Review should be granted on this issue.

III. CONCLUSION

For the foregoing reasons, a writ of *certiorari* should issue to review the opinion below.[11]

Respectfully submitted,

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[11] Respondent Smith Barney argues that the writ should be denied as to it because the Investors conceded, or waived their right to appeal with respect to, two issues regarding Smith Barney's liability for the alleged misrepresentations and omissions in the "textual" (*i.e.*, non-financial-statement) portions of the Prospectus – Smith Barney's "due diligence" defense under Sections 11 and 12(2) of the Securities Act of 1933, and Smith Barney's contention that it lacked *scienter* under Section 10(b). Smith Barney Br., at i, 1, 3-4, 6. Smith Barney further represents to this Court that the lower courts ruled in its favor on both of these issues. SB Br., at 6-7. These contentions are both untrue and irrelevant to the Investors' Petition.

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